



Appendix E:

CHANGES IN LOCAL GOVERNMENT FUNDING



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The funding structure for local government, including cities, counties and special districts, significantly changed in 2004. The budget act of 2004, and subsequently Proposition 1a, instituted a number of changes in how local revenues are allocated both permanently and temporarily to help the State deal with the ongoing budget crisis. The four primary tax and revenue funds involved are Sales and Use Tax, Vehicle License Fees (VLF), property taxes, and Educational Revenue Augmentation Funds (ERAF). Cities, counties, special districts and redevelopment agencies will be contributing \$1.3 billion each year for two years (FYs 04-05 and 05-06) to help the State's finances. This \$2.6 billion in local revenue will not be repaid to any of the agencies.

Bradley Burns Local Sales and Use Tax

In March 2004, voters approved a bond measure to finance the State's deficit. This measure, Proposition 57, gives cities and counties property tax payments in lieu of the ¼ cent sales tax they would normally receive. The reduction in the local sales tax is accompanied by an increase in a special state rate specifically designated for bond repayment. The State Board of Equalization determines the compensation amounts for each city and county, and County Auditors transfer the funds from the countywide ERAF to the local agencies. School agencies are fully compensated for the reduced ERAF by the State's General Fund. This process is generally referred to as the "Triple Flip" and became effective July 1, 2004. The amount received as "*property taxes in lieu of sales tax*" will increase each year based on the growth in sales and use tax revenue for each jurisdiction. This is expected to yield \$1.2 billion annually for the State's Fiscal Recovery Fund. With the approval of Proposition 1a, cities and counties are guaranteed the return of the ¼ cent sales tax when the Proposition 57 bonds are retired.

Vehicle License Fees

In 2004, the State permanently reduced the Vehicle License Fee (VLF) from 2.0% to 0.65% of the value of the vehicle. Previously, the State was offsetting 67.5% of the tax through the General Fund, so the effective tax rate for local agencies remains the same. However, \$4.1 billion in backfill revenue that the State previously would have given counties and cities has been eliminated and replaced with property taxes, on a dollar-for-dollar basis. (The VLF backfill from FY 03-04 will still be repaid in FY 06-07.) The 0.65% VLF fees that are collected will be used to fully fund current health and welfare programs primarily provided by counties.

The remaining revenue will be used to reimburse the State for program administrative charges and \$54 million in funding for Orange County's debt service. The balance will be allocated to cities on a per capita basis. VLF funding will increase annually based on changes in VLF revenue and each jurisdiction's population growth relative to growth in all cities in the state.

The "*property taxes in lieu of VLF*" compensation will be calculated by the Department of Finance (DOF) based on the jurisdiction's expected VLF backfill allocation prior to the change. Going forward, FY 04-05 will be used as the base year; subsequently, each city's and county's property tax in lieu of VLF reimbursement amount will increase in proportion to the change in gross assessed valuation of real property for the jurisdiction.

From FY 04-05, unincorporated areas that want to form a new city will no longer receive the VLF "bump", or three times the number of registered voters in the incorporating area, as a boost to the new city. This, along with the provisions of revenue neutrality, will likely prevent future incorporations. Annexations are treated somewhat differently. The legislature adopted AB2115, which provides for no "property tax in lieu of VLF" to replace lost VLF revenue in annexation areas. The fiscal viability of annexations may be negatively impacted, depending on the extent of development of the land at the time of the annexation. The more vacant the land, the more future property tax revenue growth potential, and the more property tax revenue growth captured by the annexing jurisdiction.

Funding from "property taxes in lieu of VLF" will be reduced by \$700 million for cities and counties in FYs 04-05 and 05-06 as described below. Full funding allocations will be restored in FY 06-07.

Educational Revenue Augmentation Funds

Proposition 98 required the State to fund education at specified levels. In order to meet this obligation, the State enacted legislation that caused local government to bear some of the financial responsibility for this mandate. County Auditors were directed to establish Educational Revenue Augmentation Funds (ERAF) by transferring a portion of local property tax revenues from local government into the fund. ERAF supports school districts, county offices of education, and community college districts. The first ERAF shift of \$1.3 billion occurred in FY 92-93. ERAF III for FYs 04-05 and 05-06 includes \$1.3 billion each year, with the burden allocated as follows:

ERAF III Annual Contribution

Counties	\$350 million
Cities	\$350 million
Special Districts	\$350 million
Redevelopment Agencies	\$250 million
Annual Total (04-05/05-06)	\$1.3 billion

The basis varies for determining the amount an individual county, city or district will contribute. County contributions are based on each county's share of VLF revenues. City contributions are based on shares of sales tax, property tax, and VLF revenues. The minimum city contribution is 2% of its general fund revenues and the maximum is 4%, as reported in the FY 01-02 State Controller's city report.

Special district contributions have two levels: enterprise districts will contribute 40% of property tax revenues and non-enterprise agencies will contribute 10% of property tax revenues. The maximum contribution by any special district is 10% of total revenues. Transit districts will contribute up to 3% of their property tax revenues. Mosquito abatement districts are exempted, as well as fire, police, hospital/health care, library and veterans' memorial districts.

Redevelopment agencies will collectively contribute \$125 million based on gross tax increment and \$125 million based on net tax increment. Agencies may be granted an extension based on the remaining life of the redevelopment agency.

The cities and counties will make their "contribution" through a reduction in the amount they receive from the State for "property taxes in lieu of VLF". The special districts will contribute directly to their county's ERAF.

The DOF calculates the amount each special district must contribute; the County Auditor-Controller will reduce each agency's tax increment by this amount and transfer the funds into the ERAF. Because the ERAF contribution is based on property tax revenues from two years ago, there may be instances where a district's current tax increment is not sufficient to cover the required ERAF contribution if revenues have declined recently.

Local agencies will receive their full tax increment again beginning in FY 06-07.

Proposition 1a

In November 2004, Proposition 1a was approved by voters to establish constitutional protection for local revenues in the future. The aggregate amount of city, county, special district and redevelopment property tax revenues collected within each county are protected as follows:

- Future property taxes cannot be shifted by the Legislature to ERAF or schools, or be used to support state-mandated programs, or for any other purpose.
- Each local government's property tax revenues are protected at current levels, unless reallocated by a 2/3 vote of the Legislature. No reallocations may occur until FY 08-09.

Suspension of this constitutional protection can only occur if the Governor declares a “significant financial hardship”. The Legislature must approve it by a 2/3 vote on a bill that is separate from the State’s budget bill. If the suspension is enacted, several requirements will be placed on how local revenues are treated:

- Revenue shifts made at the time of the suspension will be considered a loan
- Aside from the \$2.6 billion contributed in FY 04-05 and 05-06, no borrowing or shifting may occur again until FY 08-09.
- No borrowing or shifting may occur more than twice within any 10-year period.
- No borrowing or shifting may occur if previous suspension loans or the VLF Gap loan (from FY 03-04) have not been repaid.
- Loans may not exceed 8% of non-education property tax revenues (generally equivalent to \$1.3 billion in 2003-04 property tax revenues).
- The Legislature is constitutionally required to pass a statute to fully repay the loan with interest within three fiscal years.

In addition, the State is required to fund or suspend state-mandated local programs and bans the use of property tax revenues to reimburse these programs.

Funding Summary

Change	Impact to Local Government	Impact to State
¼ cent local sales tax (cities/counties)	– \$1.2 billion	+ \$1.2 billion
Return of “property tax in lieu of sales tax” from county ERAF	+ \$1.2 billion	– \$1.2 billion paid to county ERAF
Elimination of VLF backfill	– \$4.1 billion	+ \$4.1 billion (no revenue; relieves State of former liability to local governments)
Return of “property tax in lieu of VLF” from county ERAF	+ \$3.4 billion	– \$3.4 billion
Net Contribution to State General Fund from cities/counties	– \$700 million	+ \$700 million
Contribution of special districts and redevelopment agencies to ERAF	– \$600 million	+ \$600 million (relieves State’s financial responsibility for mandated education funding levels)

It should be noted that the \$4.1 billion in property tax exchanged for VLF backfill and the \$1.2 billion in property tax exchanged for sales tax will be paid out of the county ERAF. In some counties, the ERAF will not be sufficient to cover the in-lieu payments. In this case, the County Auditors will shift the necessary funds from school shares and the school entities will be compensated from the State's General Fund.

Sources:

www.californiacityfinance.com

www.californiataxdata.com

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League of California Cities, www.cacities.org

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